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Before the Subcommittee on Select Revenue Measures
of the U.S. House Committee on Ways and Means

Hearing on the "Financial Products Tax Reform Discussion Draft"
March 20, 2013

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to provide Vanguard's perspective on the financial products tax reform discussion draft issued by Chairman Camp. My name is Shawn Travis. I am a principal and senior counsel at Vanguard, where I manage a global tax advisors team that, along with Vanguard's investment management, accounting, and senior leadership teams, is keenly interested in how financial products should be taxed in the future.

Vanguard approaches these reform proposals from a distinctive business perspective. We are one of the largest mutual fund complexes, managing more than $2.1 trillion in more than 180 U.S. funds and serving more than 25 million U.S. shareholder accounts.[1] We are also the only *mutually owned* fund complex. The funds we manage actually own Vanguard, giving us a singular mission: to provide our funds' shareholders the best chance for long-term investment success.

We believe derivatives can, when used prudently, play a meaningful role in pursuing this mission. We use "plain vanilla" swaps, currency forwards, and futures contracts in managing our mutual fund portfolios, typically having an aggregate notional value of between $5 and $10 billion. These derivatives enable us to reduce transaction costs in our funds, manage portfolio-level risk more precisely, and accommodate large cash flows into and out of our funds with minimal disruption to their long-term investment strategies. For example, U.S. Treasury futures enable us to adjust a bond fund's overall interest rate risk while avoiding potentially unfavorable bid-ask spreads and preserving any value derived from holding the specific bonds previously selected. Interest rate swaps permit us to buy both fixed and floating rate bonds, depending on what is available in the marketplace, and then convert their coupon structure to better achieve a fund's investment objective. And equity index futures allow us to keep a fund fully invested while waiting for dividend receivables to arrive in cash.

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[1] Vanguard's U.S. mutual funds include indexed and actively managed equity, bond, balanced, and money market funds. Vanguard also manages more than $200 billion in additional assets in funds domiciled in Australia, Canada, Ireland, and the United Kingdom. In addition, Vanguard has a broker-dealer that provides clients the ability to buy and sell stocks, bonds, and other securities.

As useful as derivatives can be in managing our funds for the long term, we don't find much alignment between our client-focused approach and the current tax regime for derivatives. We encourage our clients to take a straightforward approach to investing, to stay the course over the long term, and to expect "plain talk" about capital markets. By contrast, the current tax regime for derivatives is complex, elective in outcome, and not easily explained to our clients.

We spend more resources than we would like keeping up with this complex tax regime, avoiding its pitfalls, and ensuring our systems properly comply. We find it curious *and discomforting* that current law allows taxpayers to elect their tax treatment—that economically similar derivatives can result in, alternatively, (1) deferral and long-term capital gain, (2) a mixture of long-term and short-term gain, or (3) ordinary income. We believe we should compete on how effectively we manage our funds and serve our clients rather than on how creative we can be with the tax rules.[2]

We are, therefore, encouraged that the discussion draft aims to reduce the importance of tax considerations in making investment decisions, particularly with respect to derivatives. That goal is consistent with our belief that the tax law should provide clear rules that apply uniformly and give businesses like ours a durable regime that is easy to comply with. The draft proposals represent a significant step toward that goal. In support of that effort, we would like to share some specific thoughts on the mark-to-market and average cost basis proposals.

<u>The Mark-to-Market Proposal</u>

Mutual funds already mark their derivatives to market daily for risk-management and fund-valuation purposes. Marking them to market for tax purposes should in general be a feasible extension of what funds already do. In addition, we would not anticipate mutual fund investors objecting to mandatory mark-to-market taxation of derivatives, provided the treatment does not preclude appropriate netting of items realized from direct investments in stocks and bonds. In that regard, we have two suggestions: (1) treat mark-to-market gains and losses from derivatives as capital gains and losses, and (2) allow hedge accounting for investments in stocks and bonds that are hedged with derivatives.

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[2] Exchange-traded notes are an example of a product whose popularity is likely in part explained by gaps in current tax law. These notes are a recent and fast-growing innovation, bringing derivatives to retail investors and collecting more than $17 billion in more than 200 issues over the past five years. These notes track benchmarks—a commodity index, for example—but can in theory deliver any investment return. They also allegedly involve no tax until they are sold or mature, which could be 30 years in the future, and then they convert all income to long-term gain. These tax benefits may seem more immediate to retail investors than the *uncompensated* credit risks that they take on when relying on these derivatives to save for their futures, notwithstanding Lehman's bankruptcy and the other credit scares during the recent financial crisis.

But before turning to these two suggestions, we want first to offer some thoughts on the appropriateness of mark-to-market taxation for derivatives.

a. Appropriateness of Mark-to-Market Accounting

We understand many oppose requiring mark-to-market accounting for derivatives. They worry taxpayers will not have cash to pay tax on the "paper" gains. They worry that many derivatives will be hard to value. And they worry that taxing derivatives differently than direct investments in stocks and securities will discourage their use for legitimate investment purposes. Based on our investment experience, we generally do not share these concerns.

We have seen no indication from actual investor behavior that they are deterred from buying an investment just because it produces some "phantom" income. Retail mutual fund shareholders across the industry overwhelmingly elect to reinvest their dividends, which allows them to grow their savings over time but also requires them to pay taxes on the dividends using cash from other sources. We do understand that investors would *prefer* to defer their recognition of income from investments. But if the mark-to-market proposal were adopted, we suspect anyone who would otherwise buy "retail derivatives" for non-tax reasons would still do so and pay their taxes from other sources, just as most retail mutual fund investors do now.

We are also unconvinced that valuation presents an insurmountable obstacle to adopting a mark-to-market proposal. In our experience, retail investors expect (indeed demand) timely and accurate valuations of their investments, without regard to tax considerations. For publicly traded derivatives, providing these valuations should be easy. For other derivatives based on publicly traded property, there are well-understood models for pricing the components of the derivatives, which should provide a reasonable basis for valuing them. For derivatives that are truly difficult to value accurately, and for which no appropriate valuation can be made available,[3] the proposal could allow them to be accounted for based on an alternative accounting method. This alternative method could be based on current rules that account for interest on contingent bonds[4] or other current rules designed to prevent abusive deferral,[5] such as the treatment of gain on passive foreign investment companies[6] or from constructive ownership transactions.[7]

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[3] We observe that the central clearing and daily margin requirements for swaps (following the Dodd Frank Act and related guidance) may generally support a mark-to-market tax regime.
[4] Treas. Reg. Sec. 1.1275-4. This is sometimes referred to as "anticipatory taxation," since it imputes current income from an investment based on its anticipated return, either at a statutory rate or the expected rate of return. See, e.g., the statement of Alex Raskolnikov before the Joint Hearing of the U.S. House Committee on Ways and Means and U.S. Senate Committee on Finance, "Tax Reform and the Tax Treatment of Financial Products," December 6, 2011 (the "2011 Hearing").
[5] In his statement in the 2011 Hearing, Raskolnikov explains how some tax rules for derivatives aim to treat income as though it were recognized over the holding period of the investment.
[6] I.R.C. § 1291.

Critics of the mark-to-market proposal have fairly pointed out that adopting the proposal would arguably harden and deepen the distinctions in character and timing between derivatives and direct investments and as a result may distort investment decisions more than do the current rules. While not stated explicitly, their arguments imply that the tax planning permitted under the current rules actually mitigates the adverse effects of taxing derivatives and direct investments differently.

We disagree. In our view, the legal and economic differences between direct investments and derivatives are sufficiently real to justify different tax treatment, even if the economic exposure to a direct investment can be replicated by a derivative.

For derivatives with significant embedded leverage – such as simple forwards, futures, and swaps – the commercial requirement to post collateral on margin in effect economically marks to market the position, and the leverage itself further attenuates the investor's already broken legal and economic connection with the underlying securities. This is acknowledged even by the current rules, which resolutely decline to tax these derivatives as ownership interests in the underlying assets and already tend to corral taxpayers into mark-to-market treatment. For "pre-paid" derivatives – such as structured notes, exchange-traded notes, and deep-in-the-money options – "wait and see" accounting is too susceptible to abusive deferral and character conversion, unless the time-value-of-money component of the instrument's expected return is properly taken into account. Unhedged direct investments simply do not present the same opportunity for abusive deferral. For other types of derivatives – such as regular options – the derivative's economic similarity to the underlying asset is even more remote, which should provide an even firmer basis for taxing them differently than the underlying asset.

Because of these real differences between derivatives and direct investments, we do not believe that taxing them differently would unduly discourage the use of derivatives for legitimate investing. In fact, for us, mandatory mark-to-market accounting for unhedged derivatives would likely make those derivatives easier to use by generally simplifying accounting for them. But if the disadvantages of mark-to-market taxation prove too great for others, we still firmly believe that all derivatives should be taxed on a consistent basis and their taxation should not be based on "wait and see" but should instead be based on one of the other models for appropriately taking into account the time-value-of-money component embedded in them.[8]

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[7] I.R.C. § 1260.

[8] Raskolnikov clearly and succinctly summarized these in his statement in the 2011 Hearing. See also New York State Bar Tax Section Report 1159, "Prepaid Forward Contracts," June 26, 2008, www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1159Report.pdf. We note that Ranking Member Neal previously introduced a bill, H.R. 4912 (Dec. 2007) that would address the time-value component of exchange-traded notes. See, also, Vanguard's May 13, 2008, comment letter

While we support mark-to-market as a framework for taxing derivatives, we do want to share several thoughts on the draft's specific mark-to-market proposals.

b. Match Character

The draft proposal would require derivatives to be marked to market annually and would treat the resulting gain or loss as ordinary income. By contrast, gains and losses from direct investments in stocks and bonds would continue to be treated as capital and recognized under the current realization principles. This disparate treatment would result in character mismatches between gains and losses from derivatives and those from stocks and bonds in funds. These character mismatches across a portfolio could produce unfavorable tax results for mutual funds in particular because they cannot under current law carry forward net operating losses. Mutual funds could not as a result reduce their net annual gains from derivatives by losses on their direct investments, nor by net ordinary losses from prior years.

To avoid character mismatches between derivatives and direct investments, we suggest that all gains and losses from derivatives be treated as capital, subject to our suggestion described below for hedged investments. If this suggestion is not adopted, we ask that mutual funds be allowed at least to carry forward ordinary losses to future years.

c. Allow Hedge Accounting for Investments

Our second suggestion relates to the proposed treatment of direct investments in stocks and bonds that are hedged with derivatives. Many of the problems with the current rules for taxing financial products arise because, unlike the rules for taxing business hedges, they make little attempt to accurately account for the income and loss on investment hedges and instead try to police abusive straddling with punitive taxation. As a result, the current rules often fail to account for offsetting positions in a way that approximates economic reality and instead tax legitimate hedging transactions in a punitive manner.

The draft proposal would not ameliorate these problems. It would have no effect on hedges that are not straddles, and it would tax mixed straddles (that is, hedges involving stocks or bonds and derivatives) the same as it would derivatives. While its treatment of mixed straddles might more accurately reflect economic income than current law does, it would also tax them more harshly relative to direct investments than current law. Doing this would encourage taxpayers to take aggressive positions on the question of whether their hedges constitute straddles

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submitted to Treasury in response to Notice 2008-2, "Concerning the Timing, Character, Source and Other Issues Respecting Prepaid Forward Contracts and Similar Arrangements."

and generally discourage legitimate hedging, perhaps even more so than under current law.

We accordingly have significant concerns about this portion of the discussion draft and would suggest that its treatment of hedges and straddles be modified. Specifically, we recommend that hedged direct investments be taxed in a manner that attempts to match the character and timing of both the derivative leg and the direct leg of the hedging transaction.[9] Hedges eligible for this treatment could include all transactions that use derivatives to reduce or manage risk on stocks or bonds held by a taxpayer, either as an investment or as part of a trade or business other than dealing in stocks and bonds.[10] The existing rules for taxing business hedges could serve as a model for developing companion rules for taxing investment hedges,[11] and we would be happy to prepare a detailed proposal if helpful.

Our suggestion can be illustrated as follows. Assume one of our funds buys a fully collateralized derivative that reduces credit risk on a bond held in its portfolio. The proposal as drafted would require the derivative to be marked to market and, if the bond and derivative are a straddle, would require the bond to be marked to market, too. Our suggested modification to the proposal would allow the derivative and bond to be designated as an investment hedge. Gain or loss on the derivative would be deferred until gain or loss is recognized on the bond, and in both cases the character would be capital.

While we do support the general mark-to-market framework, we recommend permitting hedge accounting for investment assets rather than expanding the already complex straddle rules. But if the proposal is nevertheless adopted without modification, we would urge Congress at a minimum to modify how the mark-to-market treatment of derivatives and mixed straddles applies to holders of tax-exempt bonds. Unless changed, the proposal could cause tax-exempt interest to be effectively converted into taxable income as a result of the underlying exempt bond being hedged. We assume this outcome was unintended.

Average Cost Basis Proposal

Our final comments relate to the proposal to require taxpayers to use average cost basis for stocks and bonds. We commend your effort to simplify and rationalize these rules. And we agree that requiring taxpayers to use average basis

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[9] Others have previously suggested expanding the hedging rules, including William M. Paul and Andrea Kramer. See "A Hedge Timing Alternative" by William M. Paul, which appears in the Tax Notes special report *Examining the Straddle Rules after 25 Years*, published December 21, 2009. See, also, the statement of Andrea Kramer at the 2011 Hearing.

[10] We would also recommend clarifying that Section 1221 already allows hedging foreign currency risk, given that it is an ordinary item.

[11] Taxpayers can use hedge tax accounting in certain circumstances for ordinary items. See Kramer's testimony in the 2011 Hearing for examples and a discussion of limitations.

accounting could more accurately reflect economic gain and loss and reduce tax-motivated sales.[12]

Yet the proposal does involve a couple of significant changes for brokerage investors and mutual funds. First, the proposal will transform how investors view their stock and bond holdings. While the overwhelming majority of our shareholders use average cost for the shares they hold in our mutual funds, our brokerage clients and our funds themselves have never been allowed to use average cost for their direct holdings. They have instead been required to treat each purchase as having its own basis. But the proposal would require them to view their direct holdings as aggregate positions rather than specific lots purchased.

Second, investors and mutual funds will need to modify operations and systems, particularly for bonds. For example, the discussion draft elsewhere requires a bondholder to accrue market discount during his or her holding period, which increases the holder's basis in the bond. But the bondholder may also have to calculate an average basis for multiple bonds in his or her portfolio, which will involve "spreading" aggregate market discount accruals ratably over these bonds. This additional complexity may be considerable relative to any increased accuracy in accounting for these bonds.

Finally, we are concerned that requiring average cost basis may be more effective if calculated at the taxpayer rather than the account level. Taxpayers would otherwise face an incentive to open multiple accounts with a broker, or multiple accounts with multiple brokers, to recreate some tax lot flexibility. At the same time, we acknowledge that taxpayers may find it difficult to calculate and accurately report average cost across identical holdings at multiple brokers. For example, their shares of a stock held at Broker A would have a tax basis determined in part by their shares held at Broker B, even after selling all the latter shares and closing that account.[13]

We accordingly urge Congress to weigh the costs and benefits of adopting a new cost basis approach carefully and, perhaps above all, to take care that any new approach will be durable over time. In this regard, Vanguard and other financial institutions have just built systems to report cost basis to investors, as required by recent changes in law. It may surprise you to learn how expensive doing so was – Vanguard alone spent tens of millions of dollars. But these new systems do not report average cost for stocks and bonds because doing so was not previously allowed. Adding this functionality now would involve considerable additional cost.

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[12] Requiring any single method might tend to reduce the impact of tax on investment decisions.
[13] However, we understand that Canada has required taxpayers to calculate average cost basis across multiple accounts, if they have them, since introducing tax on capital gain in 1971.

In closing, Vanguard appreciates the opportunity to comment on the discussion draft and to appear at today's hearing. We believe the draft makes significant progress in simplifying a complex tax regime and reducing the importance of tax to investment decisions. We would be happy to provide further thoughts as the discussion draft is revised and the tax reform discussion continues.